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World economic situation and prospects as of mid-2008**

Summary

In the wake of turbulence in the economic environment, the United Nations baseline forecast for world economic growth has been revised downward in line with the pessimistic scenario of *World Economic Situation and Prospects 2008* published in January. The deepening credit crisis in major developed market economies, as triggered by the continuing housing slump, the declining value of the United States dollar vis-à-vis other major currencies, persisting global imbalances, and soaring oil and non-oil commodity prices are slowing growth of the global economy.

Global growth reached 3.8 per cent in 2007, but is expected to decline markedly to 1.8 per cent in 2008, with the weakness likely extending into 2009. Growth in developing countries is expected to weaken from 7.3 per cent in 2007 to 5.0 per cent in 2008 and to 4.8 per cent in 2009. The downside risks remain high, however, even under this gloomy scenario. In a not-yet-likely, but not improbable pessimistic scenario of a much more protracted downturn in the United States of America and continued international financial turmoil, the world economy could well come to a virtual standstill, with severe adverse effects on developing-country prospects of reaching the Millennium Development Goals.

For many developing countries, this sluggishness of the global economic environment is compounded by steeply rising costs of food and energy. Not only is the food crisis of great humanitarian concern, but it is also posing a threat to social and political stability.

* E/2008/100.

** The present document updates *World Economic Situation and Prospects 2008* (United Nations publication, Sales No. E.08.II.C.2), released in January 2008.

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Macroeconomic policymakers worldwide confront enormous challenges in the face of all these difficulties. The current situation calls for a multilaterally concerted plan of global action to stimulate strong and sustained demand in the global economy, to reform the regulatory framework for financial markets so as to restore confidence in the credit channels, and to alleviate constraints on the supply and adequate distribution of food and other primary commodities.

Macroeconomic trends in the world economy

1. In the wake of numerous challenges, the world economy is teetering on the brink of a severe global economic downturn. The deepening credit crisis in major developed-market economies, triggered by the continuing housing slump, the declining value of the United States dollar vis-à-vis other major currencies, persisting global imbalances, and soaring oil and non-oil commodity prices all pose considerable risks to economic growth in both developed and developing economies.

2. Additionally, the unfolding food crisis, which is not only a grave humanitarian issue, but also a serious threat to social and political stability in some developing economies, endangers the achievement of the Millennium Development Goals by reversing some of the progress towards those Goals made so far.

3. In the face of these uncertainties, the growth of the world economy, which registered a rate of 3.8 per cent in 2007, is expected to decline markedly, to 1.8 and 2.1 per cent in the outlook for 2008 and 2009, respectively. The prospects remain surrounded by much uncertainty. It is not clear whether the monetary and fiscal policy stimuli implemented in the United States of America will take effect any time soon or whether more protracted problems in financial and housing markets will push the major economy into a deeper recession with worldwide consequences. Based on conditions of the second quarter of 2008, the baseline scenario seems the most probable of the three scenarios presented, with there being less likelihood of the occurrence of the better or worse outcome (see table).

4. The baseline forecast projects a pace for world economic growth of 1.8 per cent in 2008, which is a downward adjustment from the baseline forecast of *World Economic Situation and Prospects 2008*[1] published in January, but remains close to the pessimistic scenario presented in that report. The revision is informed by further deterioration in the housing and financial sectors of the United States of America in the first quarter of 2008; this is expected to continue to be a major drag for the world economy, extending into 2009. The contagion effects of the sub-prime mortgage market turmoil on developing countries and economies in transition have so far been limited, but as the downturn in the United States protracts, a more adverse impact should be expected which would dim the prospects for reaching the Millennium Development Goals by 2015.

5. A more benign outcome is possible, if the monetary and fiscal policy stimuli implemented by the United States take effect in the course of 2008 by boosting consumer spending and restoring confidence in the business and banking sector. In this case, the world economy is expected to experience a moderate slowdown to 2.8 per cent in 2008 and a slight recovery in 2009 as growth improves to reach 2.9 per cent. In the pessimistic scenario, the world economy would slow to 0.8 per cent in 2008, followed by a sluggish recovery of 1.4 per cent in 2009 (see figure I).

[1] United Nations publication, Sales No. E.08.II.C.2.

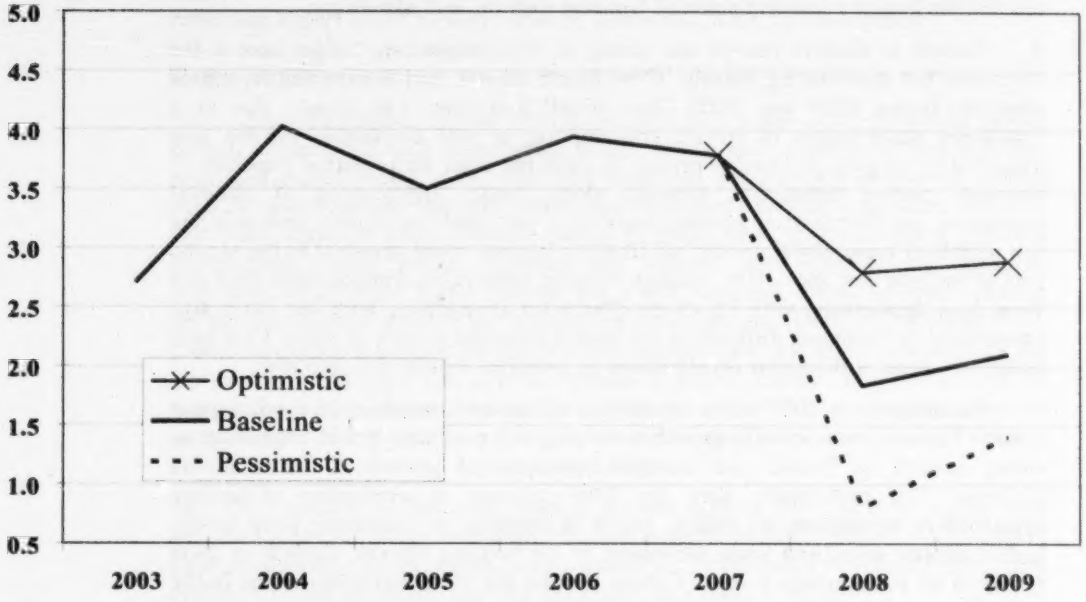
Growth of world output, and baseline optimistic and pessimistic scenarios, 2003-2009

						Baseline		*Optimistic scenario*		*Pessimistic scenario*	
	2003	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2008*	*2009*	*2008*	*2009*
World output growth	2.7	4.0	3.5	3.9	3.8	1.8	2.1	2.8	2.9	0.8	1.4
Developed economies	1.9	3.0	2.4	2.8	2.5	0.6	0.9	1.4	1.6	-0.3	0.7
United States	2.5	3.6	3.1	2.9	2.2	-0.2	0.2	1.0	1.2	-1.3	0.3
Euro zone	0.8	2.0	1.5	2.8	2.6	1.1	1.2	1.7	1.7	0.4	0.9
Japan	1.4	2.7	1.9	2.2	2.1	0.9	1.2	1.3	1.5	0.3	0.9
Economies in transition	7.2	7.6	6.6	7.9	8.4	6.4	6.1	7.3	6.6	4.5	3.0
Developing economies	5.2	7.0	6.7	7.1	7.3	5.0	4.8	6.3	6.0	3.5	3.3
Africa	4.6	5.0	5.3	5.6	5.8	4.9	4.6	6.2	6.1	2.2	1.1
East and South Asia	6.9	7.6	7.9	8.1	8.5	5.9	5.7	7.3	6.9	5.0	5.5
Western Asia	4.7	6.8	6.6	5.9	5.2	4.0	4.1	5.4	5.1	2.9	1.7
Latin America and the Caribbean	2.2	6.2	4.8	5.7	5.7	3.1	2.6	4.2	4.0	-0.3	0.9
Memo: Least developed countries	6.6	7.9	8.5	8.2	6.5	5.2	6.4	6.8	6.3	3.3	2.5
World trade growth (volume)	5.8	10.7	7.0	9.9	7.2	4.7	5.1	6.0	6.1	2.5	4.5
United States dollar exchange-rate index (annual percentage change)	-12.3	-8.2	-1.9	-1.5	-5.6	-15.0	0.0	-10.0	2.0	-11.5	-9.2
Interest rate on 10-year US Treasury notes	4.0	4.3	4.3	4.8	4.6	3.7	5.2	3.4	3.7	—	—
United States current-account balance (billions of United States dollars)	-522	-640	-755	-811	-739	-636	-544	-666	-605	-562	-418

Source: UN/DESA.

Note: The three scenarios differ mainly regarding assumptions on the housing market in the United States and financial market parameters. The baseline assumes that the average housing price will decline by 15 per cent in 2008 and remain stable in 2009. The optimistic scenario assumes that the price will decline 10 per cent in 2008 and increase marginally in 2009, while under the pessimistic scenario, similar price declines will occur in the United States, as well as in other developed economies in 2008, with more moderate declines in 2009. The baseline further assumes that financial sector problems will deteriorate further as net lending to the private sector will decline until the beginning of 2009. In contrast, under the optimistic scenario, it is assumed that the declines will hit bottom in the first quarter of 2008, with a recovery thereafter. The pessimistic scenario assumes that net lending to the private sector will come to a standstill in 2008, with some recovery in 2009.

Figure I
World economic growth under three scenarios, 2003-2009 (percentage)



Source: UN/DESA. See table for scenario assumptions.

Outlook for economic growth by region

Developed economies

6. Economic growth in the United States is expected to contract in 2008. At issue is how deep and long this contraction will be. As the housing slump continues and the credit crisis deepens, a broad array of macroeconomic indicators are already hinting at a recession: employment is in decline, consumer confidence has dropped to the lowest level in a decade, household spending growth has slowed sharply, and business equipment spending is slowing. Additionally, the presence of large inventories of existing houses, along with a continued contraction in housing activities, and a decline in residential investment by 30 per cent, strongly suggest that the implosion of housing activity will not stabilize until 2009. Against this backdrop, gross domestic product (GDP) is expected to decline by 0.2 per cent in 2008 and improve only modestly in 2009. There is the possibility of a mild recovery under the optimistic scenario if the effects of the policy stimuli gather enough strength to restore the functioning of the credit markets and stabilize the housing slump. However, given the heightened uncertainties in the financial system, as well as the large potential for further deterioration in house prices, risks cannot be ruled out for an unusually severe recession, as under the pessimistic scenario.

7. Japan's economy expanded by 2.1 per cent in 2007 and is expected to slow in 2008, owing in part to weakened private consumption, and tight fiscal policy.

Though gross fixed investment is expected to remain relatively robust, a slowdown in the United States economy will place additional pressure on Japanese exports, of which 20 per cent go to the United States. Second-round effects from Asia, which absorbs the largest combined share of Japanese exports, will also occur.

8. Growth in Western Europe was strong in 2007, registering 2.6 per cent in the euro zone but decelerating sharply in the fourth quarter, and is expected to remain sluggish during 2008 and 2009. The initial slowdown was mostly due to a significant deceleration in private consumption as real disposable income was impacted by surging commodity prices. To date, the other major global impulses — financial market turbulence, slowing global trade, appreciation of national currencies, and deteriorating housing markets — have had less impact. However, the full effects of these global shocks are likely to become more apparent in the second half of the year and into 2009, through slowing exports, as demand from East and West Asia decelerates, with knock-on effects for investment, with the latter also constrained by financing difficulties. Growth is expected to slow to about 1 per cent in the euro area, with similar decelerations in countries outside the euro area.

9. Performance in 2007 of the economies of the new members of the European Union (EU) was robust, with growth averaging 6.0 per cent. It was supported by strong growth in Poland and stronger-than-expected growth in Slovakia and Slovenia. The preliminary data for 2008 indicate a weakening of private consumption throughout the region, partly in response to increasing price levels, higher interest rates, and some slowdown in the housing market. Growth in 2008 will slow by 1 percentage point in Central Europe and more noticeably in the Baltic States against a backdrop of weaker growth in the EU-15, a possible reversal in capital flows to the region, and a sharp slowdown in domestic credit growth, with repercussions for private consumption and investment.

10. As regards other developed economies, growth in New Zealand and Australia is expected to slow in 2008, owing to weaker consumer demand; while Canada's economic activity is also expected to slow, owing to weaker external demand, impacted by the United States recession and the appreciation of the Canadian dollar.

The economies in transition

11. Among the economies in transition, those belonging to the Commonwealth of Independent States (CIS) grew 8.6 per cent in 2007, owing to strong growth in the Russian Federation and Ukraine and other smaller economies. High prices of commodities, such as oil, gas, metals and cotton, continue to boost growth in the resource-rich economies. Robust domestic demand — underpinned by rising real wages and continued recovery of investment — maintains its momentum throughout the region. In the outlook, economic performance is expected to moderate in 2008 as weaker global prospects and a slowdown of credit growth materialize. Further deterioration will cause prolonged dampening in investment and consumption in some economies, lowering demand for exports from the rest of CIS. Under the pessimistic scenario, the oil exporters in this region are expected to witness declining oil revenues and considerably lower growth in the outlook.

12. Economic activity strengthened in South-Eastern Europe in 2007, with GDP growth having reached 6.0 per cent. Robust domestic demand, especially private consumption and fixed investment, remains the driving force behind the economic expansion, boosted by the ongoing credit boom and increased real wages. External

imbalances continue to widen in the region, pushed by strong imports of consumer and capital goods and higher oil prices. Towards the end of 2007, output growth began decelerating and lower growth is expected in 2008 and 2009, partially reflecting tighter credit conditions and a slowdown in the EU economies.

Developing economies

13. Africa maintained robust growth in 2007 at 5.8 per cent, driven by strong global demand and high commodity prices, along with macroeconomic stability, increased capital flows, debt relief and improved performance in non-oil sectors such as agriculture and tourism. Africa also witnessed a decline in political conflicts and wars, although peace remains fragile in some parts of the continent. Growth performance varied across countries and regions, with oil-exporting countries recording, on average, higher growth, but it still remained below the level required for the continent to achieve the Millennium Development Goals. In 2008 and 2009, growth is expected to slow, owing to rising inflation, and a sharper slowdown in the United States economy with adverse impacts on export demand from Europe and the rest of the world. Under the less likely, but not improbable pessimistic scenario, demand for African exports would weaken considerably and growth could drop to 2.2 per cent in 2008 and to 1.1 per cent in 2009.

14. GDP growth in East Asia reached 8.8 per cent in 2007, slightly higher than expected owing to robust investment and net exports. In 2008, growth is expected to ease considerably as the region faces a slowdown in the major developed economies and high prices of energy and raw materials. In China, GDP growth is expected to moderate notably as a result of deceleration in exports, as well as other curbing effects, such as tightening monetary policy, appreciation of the renminbi and rising labour costs. Because of the existence of strong trade ties with the United States and other industrialized countries, output growth would slow to 5.0 per cent in 2008 under the pessimistic scenario.

15. Economic growth in South Asia expanded by 7.4 per cent in 2007, supported by strong growth in India and Pakistan due to strong private consumption and fixed capital formation. Solid domestic demand in both countries has also buoyed growth in import volumes, while the accelerating rise of commodity prices increased import values. Consequently, current-account deficits in both countries are widening. In the outlook, a moderation of growth is anticipated for 2008. The Islamic Republic of Iran will continue to benefit from strong oil prices, but high commodity prices are beginning to take their toll on the region. Additionally, the recession in the United States will drag down growth significantly, as it is the primary export market for India and Pakistan.

16. Western Asia recorded robust growth of 5.2 per cent in 2007 as oil revenues contributed to improved fiscal and trade-account positions in the oil-exporting economies, and encouraged investment expenditures in the larger economies of Saudi Arabia and the United Arab Emirates. Such growth, however, is being counterbalanced by a slowing trend in the oil-importing economies, which are facing, in addition to weakened consumer demand, the dual effects of rising oil import prices and slowing export demand from the major developed economies. A slowing of growth is expected in 2008 as the global economic downturn will further weaken the demand for oil and non-oil exports from the region. In addition, global credit tightening will put a squeeze on foreign direct investment (FDI) and other

capital inflows, which is of particular concern for Turkey, which relies heavily on capital inflows to finance its growing deficit.

17. Economic performance in the Latin American and Caribbean region in 2007 was better than originally projected in *World Economic Situation and Prospects 2008*. Output growth reached 5.7 per cent owing to the robust performance of Brazil's services and agricultural sectors and strong overall growth in Mexico. A substantial slowdown is expected in 2008, with most of the contagion coming through the current account owing to the region's close ties with the United States, but also Europe and China, the other main trading partners. Remittances, especially to Mexico and Central America, have started to decline, discouraged in part by the weak dollar. Net exports are expected to be stagnant owing to weaker external demand, while the import bill of most countries will increase as prices of food and oil reach record levels. Public and private investments are also expected to weaken owing to tightening of monetary and fiscal policy. Although contagion from the financial side has been relatively contained, a combination of increased international turmoil and lower economic activity in the region could trigger problems in the financial markets of the region's emerging market economies. Under the pessimistic scenario, the region would enter into an outright recession on the back of strongly weakening demand for exports from the region.

18. Growth in the group of least developed countries is expected to decelerate from 6.5 per cent in 2007 to 5.2 per cent in 2008, owing to continued slowing in Myanmar, which may turn more dire in the wake of the devastation caused by the cyclone that raged in May 2008 including the toll of the disaster on its victims, along with a moderation of growth in Ethiopia and the Sudan, both strong contributors to growth in this group of economies. In the short term, increasing inflationary pressure is a major downside risk for the least developed countries, owing to high energy prices and, most urgently, to rising food prices, which pose a threat to stability and have sparked social unrest in net food importing countries such as Bangladesh, Burkina Faso, Haiti, Mauritania and Yemen.

Employment outlook

19. Amid a slowing economic environment, the *employment* situation has remained resilient across most developed economies as falling unemployment rates and improved employment levels continue to impact on positive wage performance. However, labour-market conditions have begun to weaken in the United States and some of the developing economies where employment gains have slowed or started to recede, a trend that is expected to spread to other economies as further weakening of economic activity continues in 2008 and 2009.

20. The employment situation in the United States has been deteriorating since mid-2007. An outright contraction of payroll employment began in the first quarter of 2008 and unemployment had risen from about 4.5 per cent in mid-2007 to 5.1 per cent in March, with further deterioration expected. In Western Europe, strong employment growth, together with improving wages, has provided stimulus to the economy. Unemployment rates in the euro area reached 7.1 per cent in early 2008, the lowest level since the beginning of the Economic and Monetary Union. Labour markets also continued to improve in the new EU member States, with unemployment rates declining to single digits in almost all countries in the region. However, with economic growth slowing, unemployment is expected to rise

marginally across Europe in 2008 and 2009. In Australia, New Zealand and Canada, the employment situation is also stable in spite of the expected slowdown in these economies, while Japan's labour markets offer a mixed picture. Unemployment is expected to remain around a multi-year low of 3.8 per cent in 2008, but nominal wages are expected to remain weak.

21. Among the economies in transition, unemployment in CIS continues to decline, largely owing to the expansion in the construction and services sectors in some countries, particularly the Russian Federation. The pace of this trend, however, lags far behind recent high output growth rates. In South-Eastern Europe, labour markets improved somewhat in parallel with strong economic growth of several years duration, but unemployment rates still remain exceptionally high.

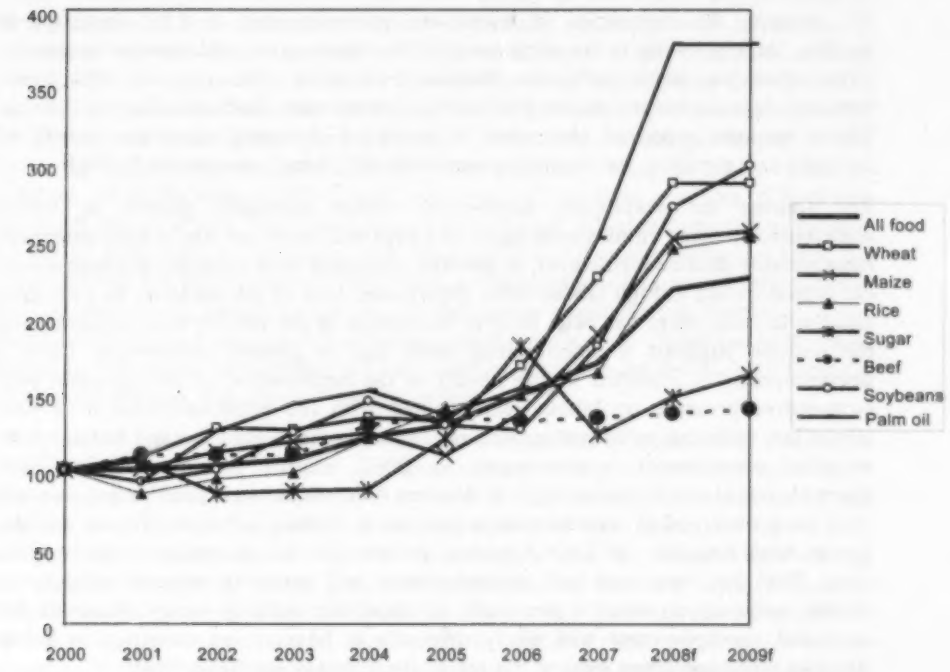
22. Among the developing economies, robust economic growth in Africa contributed to some employment gains in Egypt and Morocco where unemployment rates steadily declined. However, in general, unemployment rates remain high across the region owing to high labour-force growth and lack of job creation. In East Asia and South Asia, there has been little or no change in the employment situation and the outlook suggests a deteriorating trend due to growth moderation. China's unemployment is expected to rise mildly as the appreciation of the renminbi puts competitive pressure on labour markets and with the implementation of a new labour law reducing incentives to hire and retain workers. Pakistan and India, which recorded employment improvements in 2007, expect deterioration in 2008. Unemployment levels remain high in Western Asia and no significant improvements have been observed as unemployment persists in Jordan, Lebanon, Yemen and the Syrian Arab Republic. In Latin America, the trend in labour-market improvements since 2004 has stagnated and unemployment will probably increase slightly or remain constant at about 8 per cent, as economic activity slows. Most of the increased unemployment will likely originate in Mexico, as countries in South America will experience weaker, but relatively robust economic activity.

Outlook for inflation

23. The rise in commodity prices seemed to be the single most important factor affecting *headline inflation* around the world, especially since the second half of 2007. In addition to the continued rise in oil prices, world food commodity prices increased by 25 per cent in 2007 and had further stepped up their pace to an annual rate of 57 per cent by March 2008 (see figure II).[2] Oils and fats experienced the highest growth, followed by cereals, dairy products, and meats. These prices are expected to continue rising in 2008 and remain at high levels in 2009 before descending.

[2] Based on data in Food and Agriculture Organization of the United Nations, Crop Prospects and Food Situation, No. 2, April 2008.

Figure II
Commodity food price index: trends and forecast, 2000-2009



Source: Based on United Nations Conference on Trade and Development (UNCTAD) commodity price index. Forecast made by UN/DESA.

24. Other factors putting pressure on inflation were excess capacity utilization and higher wages. In addition, many countries faced the dilemma of choosing between controlling inflation or stimulating the economy through looser monetary and fiscal policies. Thus, global inflation is expected to accelerate in 2008 to 3.7 per cent despite a slowdown in growth. In the baseline outlook for 2009, inflation is expected to slow as aggregate demand will continue to be weak.

25. Although inflation decreased to 2 per cent in 2007 in the developed economies, it is expected to rise to 2.7 per cent in 2008 and taper off to 1.6 per cent in 2009. Inflation in the United States is at 4 per cent, driven by rising energy and food prices, but is expected to decelerate along with demand in the outlook. Similarly, inflation in Western Europe reached 3.6 per cent in March, driven by energy and food prices. Given the slowing of activity and possible levelling off of energy and food prices in the outlook, inflation is expected to reach 2 per cent during 2009. The new EU members experienced an upsurge in inflation in 2007, which is expected to continue in 2008 as supply and demand side pressures persist. Even in Japan, where inflation was practically nil in 2007, the increase in the prices of oil and food has become a significant factor bringing the 2008 forecast to 0.7 per

cent. Australia and New Zealand are both expecting higher inflation in 2008 owing to high levels of capacity utilization, a tight labour market and higher commodity prices. In contrast, Canada expects less inflation backed by a strong domestic currency.

26. The economies in transition are expected to return to double-digit inflation rates in 2008, especially in CIS, where loose monetary and fiscal policies, shortages in agricultural products and electricity contributed. In contrast, inflation decelerated in the South-Eastern European countries despite vibrant activity in 2007. However, prices are expected to rise again in 2008 owing to rising food and energy prices.

27. Among the developing countries, since about half of the consumer basket of goods in many economies consists of food products, increases in global food prices have a significant effect on inflation, having contributed from about one third to over half of headline inflation in 2007, especially in Asia and the Middle East.[3]

28. Inflation was moderate in Africa in 2007, but upward pressure is intensifying, especially in oil- and food-importing countries. Increasing food prices are a major concern in sub-Saharan Africa, where expenditures on food items constitute a high proportion of spending. Inflation in East and South Asian countries has accelerated since mid-2007 mainly owing to higher energy, agricultural and industrial raw material prices, and high capacity utilization in some economies. Inflation in the region will increase in 2008 to the highest level of the decade before slowing in 2009. Both oil exporters and importers in Western Asia are grappling with inflation, stemming from increased liquidity in the region, weakened currency caused by the dollar peg, distributional and supply constraints, and rising food and housing prices. To ease the burden on households, many economies have been increasing pensions and wages in the public sector, which may further exacerbate inflation through rising fiscal deficits. Some countries also have begun stockpiling food supplies to hedge against future price increases. In Latin America, higher food and oil prices, and strong domestic demand in the latter half of 2007, put an end in 2008 to the previous downward inflation trend. South and Central America and the Caribbean will experience the highest inflation rates in the region, with the latter feeling the brunt of high commodity prices as it relies heavily on imported goods.

Challenges in the international economic environment for developing countries

29. The international economic environment for developing economies and economies in transition has become less favourable with the deterioration of the financial crisis originating from the sub-prime debacle in the United States. Volatility in international trade and finance, particularly of international commodity and equity prices and yield spreads, has increased since the beginning of 2008. In the outlook, the international economic environment for these economies will be more challenging, as the United States economy and other developed economies slow down.

30. Growth of world *trade* decelerated to 4.7 per cent in early 2008, down from 7.2 per cent in 2007, owing to weak import demand from the United States. Imports

[3] International Monetary Fund (IMF), *World Economic Outlook, October 2007: Globalization and Inequality* (Washington, D.C., 2007, IMF).

of the United States, which account for about 15 per cent of the world total, declined in the fourth quarter of 2007 and dropped further in early 2008. As a result, dynamic exporters of manufactured goods, such as China, reported a significant deceleration of export volumes. As the United States-led global downturn continues, more developing countries will see their exports weaken, including energy and commodities exporters in Africa and Latin America.

31. The *price of oil* (Brent crude) surged to record levels of more than $120 per barrel (pb) in the first quarter of 2008. The weakening of the United States dollar, geopolitical tensions, particularly in Nigeria, and inventory declines have outweighed demand factors in determining price movements; but as demand continues to weaken in the second half of the year, owing in part to higher prices and the economic slowdown, oil prices are expected to moderate to an average of $95 pb in 2008 and $90 pb in 2009.

32. *Prices of agricultural and non-agricultural commodities* continued their rise of the past few years. While supply-side factors vary, robust global demand, originating in particular from China and other fast-growing emerging economies, has been a common factor. Higher oil prices have also contributed, either by directly increasing production costs or through an indirect substitution effect. For example, higher oil prices have induced biofuel production, increasing the prices of corn, soybeans and oilseeds. In the outlook, prices of most agricultural commodities are expected to flatten out, with the exception of major food commodities (wheat, maize, rice and soybeans), whose prices are expected to increase in 2008 before levelling off in 2009. Prices of metals and minerals are expected to retreat moderately in 2008 and 2009.

33. The *terms of trade* for many developing countries have improved over the past five years, as the international prices of oil and other primary commodities rose. Economic fundamentals, such as expanding global demand, supported this rise, but cyclical and speculative factors have also played a role. For example, the depreciation of the United States dollar and the financial crisis pushed prices to unsustainable levels as investors flocked to commodity markets for better returns. Such herding behaviour has led to increased volatility and may pose risks for a significant correction in the future.

34. Net importers of energy and food commodities, in contrast, are suffering adverse terms-of-trade effects. Food prices, which increased by 14 per cent in 2007 and have increased further in 2008, have become a threat to the poor and to the prosperity and social stability of many developing countries (see box).

Challenges of soaring food prices and inflation for developing countries

Food products like wheat, palm oil, soybean oil, soybeans and rice experienced alarming price increases (in descending order of magnitude from 113 to 52 per cent between April 2007 and March 2008). These prices are expected to continue rising in 2008 and to remain at high levels in 2009 before descending in 2010. The speed and level of the recent spikes in food prices can be attributed to a combination of simultaneous events that affected the food commodity market during the past few years on the side of both demand and supply.

Rising incomes and accelerating urbanization in developing countries have led to a strong increase in the demand for meat products, which in turn require more grains for animal feed. Additionally, environmental and energy-security concerns have increased the demand for biofuels, which has required greater production of corn and sugar cane. Almost half the increase in the demand for major food crops in the United States during 2006-2007 was to satisfy the increased need for inputs for corn-based ethanol production in the United States.[a] In addition, almost all of the increase in the world supply of maize generated between 2004 and 2007 was used for biofuel production in the United States.[b]

The world food supply (measured by the volume of cereal production) increased by 5 per cent in 2007, but the increase falls short of the increase in demand. Some of the production gains were offset by a series of political conflicts, and severe weather, including droughts and floods, which have caused considerable damage to crops in some parts of the world, making access to food more difficult. This occurred in, among others, several countries in the sub-Saharan region, Afghanistan, Australia, Bangladesh, China, Indonesia, Iraq, Nepal and Sri Lanka. In addition, the scarcity of water in some countries (for example, Saudi Arabia) has greatly reduced the production of grains in their parts of the world. Added to this, the concomitant increase in the price of oil has increased transportation costs, and the cost of fertilizers.

Continuing demand pressures and lagged supply effects are expected to keep food prices at high levels in the outlook, which would have serious consequences, particularly for net food-importing economies. Most poor households in developing economies that are net food buyers will also be adversely affected by higher food prices. According to estimates by UN/DESA, the surge in global food prices since 2006 has put an additional 109 million people at risk of falling under the poverty line of $1 per day.[c] Most of the additional poor would come from South Asia and Africa, with Africa being the hardest hit in relative terms.

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[a] International Monetary Fund, *World Economic Outlook, April 2008: Housing and the Business Cycle* (Washington, D.C., IMF, 2008).

[b] World Bank, "Rising food prices: policy options and World Bank response", background note for the Development Committee, Washington, D.C., March 2008.

[c] Estimates are based on household survey data covering about 80 per cent of the population in developing countries.

35. The *external financing costs* for emerging market economies remain low, but have increased with the recent financial turmoil. The spreads in the Emerging Markets Bond Index (EMBI) rose, on average, over 100 basis points from the all-time lows registered in the first half of 2007. The increases in the spreads for emerging market economies running external deficits, such as a few economies in transition, are wider than average, indicating concerns about the risks for a disorderly adjustment of the external imbalances. Meanwhile, the benchmark interest rates underlying the external financing costs for emerging market economies have decreased as a result of a "flight to safety" in the credit markets of developed countries and cuts in United States interest rates. Downward risks exist, particularly if financial market conditions in the developed countries continue to deteriorate and the large current-account deficit of the United States adjusts abruptly.

36. *Capital flows* to emerging market economies reached record highs in 2007, as their economic strength attracted international investors. The financial turmoil and interest rate cuts in the United States prompted an outflow of capital from the United States to emerging market economies for higher yields. In the outlook, however, capital flows to these economies are expected to moderate. In fact, net flows have slowed down since the outbreak of financial turbulence in August 2007, although they increased significantly in gross terms. This is the result of an increase in outward investment from developing countries, as well as, in early 2008, a large sell-off by international investors of their stakes in emerging equity markets. The latter is an indication of increased risk-aversion of international investors towards emerging market economies. Since capital flows to these countries tend to be pro-cyclical, these are expected to decline with the projected slowdown of their economies.

37. *Official development assistance* (ODA) declined again in 2007 after it had also dropped in 2006. In 2005, ODA was up, but mainly owing to debt relief provided, especially for Iraq and Nigeria. Most donors are not on track to meet their commitments to scale up aid and will need to make unprecedented increases to meet them by 2010. The ratio of ODA to gross national income (GNI) of the Development Assistance Committee (DAC) members dropped from 0.31 per cent in 2006 to 0.28 per cent in 2007. Excluding debt relief grants, DAC members' net ODA rose by 2.4 per cent. ODA to sub-Saharan Africa, excluding debt relief, increased by 10 per cent, but donors will face a real challenge in meeting the promise made by donors at the Gleneagles G-8 Summit to double aid to Africa by 2010. More efforts are needed to make aid flows more predictable and counter-cyclical, thereby improving its effectiveness.

38. The outflows of capital from emerging to developed market economies continued to be larger than the inflows. On balance, emerging market economies are net lenders to the rest of the world, financing the external deficits of the United States and other developed economies. In the current financial crisis, capital outflows from emerging market economies are an important source of capital to beleaguered banks in the United States. Capital outflows from emerging market economies to low-income countries, particularly in Africa, have also increased. Some capital outflows from emerging market economies involve investments from sovereign wealth funds, whose lack of transparency has generated some concerns in developed countries.

39. Most of the net transfer of financial resources from developing to developed countries is through international reserves accumulation, however. The total value of *official reserves* of developing countries reached over $3 trillion in 2007. Foreign exchange reserves of China alone amounted to $1.5 trillion by the end of 2007. The amassed reserves have strengthened the capacity of these countries to deal with external shocks, but they also bring costs and policy challenges. One challenge is managing large foreign exchange reserves efficiently. With a depreciating dollar, there are increasing costs associated to holding large amounts of reserves, as most are held in dollar-denominated assets. There has been some diversification into other major currencies in order to mitigate the risk of further asset value losses. One possible reason for the weak reserve diversification is that central banks fear that a move away from dollar-denominated assets could precipitate an even stronger dollar depreciation and loss of the value of their reserve holdings. However, the accumulation of large official reserve positions by developing countries is intrinsically related to the widening global imbalances and not addressing these imbalances could lead to an abrupt loss in confidence in the international reserve currency. A hard landing of the dollar, in turn, would quickly erode the degree of "self-insurance" that developing countries have built up over the past decade.

40. The depreciation of the United States dollar has accelerated in 2008. The value of the United States dollar vis-à-vis other major currencies has dropped by nearly 40 per cent since 2002, reaching the lowest level since the collapse of the Bretton Woods system. The dollar has also depreciated against most currencies in developing and transition economies, including the Chinese renminbi and currencies of commodity-exporting countries, except those pegged to the dollar. In the outlook, the dollar is expected to weaken by 15 per cent vis-à-vis major currencies in the baseline scenario, as the differentials in growth and interest rates continue to expand and the external deficit of the United States, although narrowing, is still far from sustainable.

Policy challenges

41. The tenuous economic environment carries with it serious challenges for the global economy. Under the baseline forecast, the expectation is that neither monetary nor fiscal policies proposed so far will stimulate domestic spending in the United States and the resulting recession will have adverse spillover effects on the rest of the world. Under the pessimistic scenario, the unravelling of household indebtedness in the United States and a number of developed economies such as the United Kingdom of Great Britain and Northern Ireland, Spain and Australia may turn into much greater financial instability. All developed regions will experience a recession of some degree while growth in developing countries will be strongly affected through both trade and financial channels. Such scenarios, which involve considerable economic stress worldwide, require serious consideration and call for decisive efforts towards concerted policy actions.

42. The impending slowdown and credit crunch in the United States have prompted domestic expansionary policies, but the main driver of a recovery should be external demand. In other countries, there seems to be a resistance to implementing expansionary policies, either because of confidence in the strength of the global economy or because of concern with inflationary pressures due to higher commodity prices. Meanwhile, global imbalances continue to be massive from a

historical perspective, and any disorderly unwinding would have drastic implications for global trade and finance.

43. The *World Economic Situation and Prospects* reports for 2006,[4] 2007[5] and 2008 have repeatedly stressed the need for coordinated policy action to reduce global imbalances while averting an economic downturn, suggesting a rebalancing of domestic demand between surplus and deficit countries and a smooth realignment of exchange rates. The reports also reflected on the factors causing such imbalances and proposed longer-term measures to prevent their reappearance in the future, such as reforming the international reserve system and strengthening financial regulation and safety nets.

Partial but limited progress in multilateral consultations

44. Addressing global imbalances, while maintaining global growth, has been the main focus of the Multilateral Consultation on Global Imbalances, first convoked by the International Monetary Fund (IMF) in June 2006. Its most recent report highlights the following advances made in the main suggested avenues for policy action:

(a) There has been some progress towards global rebalancing: China is on the path of increasing public spending; Saudi Arabia is ramping up investment in social and economic infrastructure, while boosting oil exploration and refining capacity; and in the United States, fiscal consolidation has advanced;

(b) There has been significant realignment of exchange rates. China has continued its steady appreciation vis-à-vis the dollar and the dollar has depreciated further against all other major currencies.

45. While these factors seem to have contributed to narrowing global imbalances, the risks associated with a visible worsening of the world economic situation have heightened nonetheless. In particular, demand in the United States is softer than envisaged when the first multilateral consultation took place. More aggressive expansion of demand in the rest of the world is thus needed. Moreover, this is seen as a "period of fragile confidence" marked by the probability of a recession in the United States combined with credit contractions in the main financial centres and sharp fluctuations in exchange, commodity and energy markets.

46. A more comprehensive concerted plan of action should aim at the following complementary objectives:

- To help alleviate supply constraints and improve food security
- To stimulate strong and sustainable demand in the world economy so as to compensate for the impending adjustment of the household sector in various developed economies
- To re-establish confidence and reactivate reliable credit channels so as to maintain employment and income-generating activities

[4] United Nations publication, Sales No. E.06.II.C.2.
[5] United Nations publication, Sales No. E.07.II.C.2.

Dealing with the food crisis

47. Internationally concerted actions are needed to address the food crisis. In the very short run, the humanitarian and food emergency needs have been clearly spelled out by the World Food Programme (WFP) and the Food and Agriculture Organization of the United Nations (FAO). Additional food and monetary aid is necessary to alleviate the food crises. As a response to shortages, export duties and controls do not seem to be effective in securing domestic supply and controlling domestic prices. Additionally, such measures limit the availability of goods, creating further price increases at the regional and global levels.

48. Abolishing agricultural subsidies in developed countries will probably benefit farmers in developing countries. However, in the short run, the elimination of those subsidies will likely increase world food prices even further and would require compensatory measures for affected countries, especially the food-importing low-income countries. In the medium term, it is imperative to evaluate the forces behind price movements in combination with world availability of resources and the techniques used to improve efficiency of production and protect the environment; it is also important to monitor the markets themselves.

49. The present food crisis has revealed the consequences of a long overdue problem of low agricultural productivity and the effect of this neglect on the poor. In the long run, increasing productivity through investments in water supply, infrastructure, improved seeds and fertilizers, education, and agricultural research and development will be essential not only in dealing with the present food crisis, but in addressing the problem of persistent and widespread rural poverty. By improving access of producers to agricultural land, affordable inputs, and infrastructure, strong gains in rural poverty could be achieved through increased food productivity. This would entail making agriculture a priority at both the national and international levels.

Global demand reflation

50. To kick-start a restructuring of demand in conditions of fragile market confidence, policymakers should consider a globally coordinated reflationary programme centred on the expansion of domestic demand in surplus countries as well as a more proactive role of government sectors.

51. A number of developed countries with some weight in the world economy, like Japan, Germany, Switzerland, the Netherlands, Norway and Canada, as well as the emerging market economies in East Asia and the main oil exporters, have a decisive role to play in engineering a more balanced and sustainable path of global growth. It should be underlined that their export-oriented strategies risk being disrupted by a global slowdown, and the losses in the value of their reserves, causing a possibly sharp dollar depreciation and further instability in major financial markets, may be huge. Meanwhile, they have much to gain from using their accumulated reserves, industrial strength and primary resources in generating income and employment and improving distribution in their domestic economies.

52. Some countries are tied by rules that rigidly limit the fiscal space. While the guiding principles of fiscal prudence are useful, in most cases, these have been put forward in the framework of an aggressive shift towards deregulation and liberalization which had a significant role in inducing the current global fragility.

Furthermore, these rules may not be sufficiently counter-cyclical to be able to trigger a large enough turnaround in the patterns of global aggregate demand.

53. A global reflation strategy should contemplate supporting growth and development in countries with limited resources, including the least developed countries. Compelled to achieve more balanced external and fiscal accounts, the Governments of many developing economies in Africa and Latin America postponed long-term investments in infrastructure and social sectors in preceding decades. The recent build-up of vast amounts of official reserves brings up the issue of a trade-off between the desire for greater "self-insurance" against external shocks and the overdue need to accelerate investment in long-term development. A reformed international reserve system and measures to stem capital volatility (see below) should also reduce the need for self-insurance through reserve accumulation at the national level. This in turn would help increase the fiscal space for increased expenditures for infrastructure development and social services.

Improving financial conditions and confidence

54. Financial markets face problems in terms of their "state of confidence" as well as their "state of credit", to use Keynesian terminology. When the economy is in a downswing, there is pressure in financial markets to continue selling, which causes further asset depreciation and write-downs and this could self-propel into a financial crisis. Governments have always been inclined to step in, in order to bail out parts of the financial sector in periods of distress, often at high costs to taxpayers. Such interventions may be justified, as failure of large financial institutions may pose systemic risks. Along with fresh credit injections into a distressed financial sector, such measures should be applied with great prudence, or else the wrong signals would be sent to the financial system, encouraging excessive risk-taking in the future.

55. More fundamentally though, more persuasive reforms of mechanisms of international financial regulation and supervision are needed. Policymakers in developed countries should pay more attention to preventing the harmful effects of financial excesses. Risk assessments by rating agencies tend to be highly pro-cyclical and tend to react to the materialization of risks (that is, after problems have emerged) rather than to their build-up. Existing tools are not very effective in addressing the consequences. International regulations on the capital adequacy of banks tend to be pro-cyclical too, requiring lenders to raise more capital only after problems in financial markets have already occurred. The Basel I rules allowed banks to hide risky loans off their balance sheets, eroding the effectiveness of regulation. The Basel II rules are more sophisticated in treating risk, but rely heavily on risk assessment models developed by the banks themselves; a major deficiency of these assessments is that they ignore contagion effects and herd behaviour intrinsic to the functioning of financial markets.

56. Both national and international prudential regulatory frameworks need to be modified to focus on the systemic components of risk build-up in financial markets. Furthermore, to be effective, the improved framework should apply equally to banks and non-banks. Regulation can be made counter-cyclical by requiring that buffers (capital adequacy) are built up during upswings in order to both restrain excesses and provide a greater cushion against losses in the downswing. Such rules should be

international so as to ensure that banks and other financial institutions do not try to evade national requirements by shifting portfolios to offshore holdings.

57. The international reserve system needs to be revised as well. Under the current system based on the United States dollar as the reserve currency, the only way for the rest of the world to accumulate reserves is for the United States to run an external deficit. Over time, such a pattern inevitably erodes the value of the dollar, enhancing costs incurred by countries for continuing to hold vast amounts of reserves, and this may well cause a run on the dollar, probably with strong destabilizing consequences which will be felt worldwide.

58. The emergence of a new, supranational currency, based on scaling up special drawing rights, is probably the best solution for redesigning the global reserve system in a stable way, but this can only be a long-term option. The more immediate reform would be to promote an officially backed multi-currency reserve system. This idea should be as compelling as the pursuit of a multilateral trading system. Similar to multilateral trade rules, a well-designed multilateral financial system should create equal conditions for all parties and prevent unfair competition and an asymmetric burden-sharing of exchange-rate adjustments. It should also help to increase stability in the international financial system.